Bank of New Zealand

BNZ Weekly Overview

23 February 2006

FINANCIAL MARKETS DATA

	This week	Week ago	4 wks ago	3 mths ago	Yr ago	10 yr average
Official Cash Rate	7.25%	7.25	7.25	7.00	6.50	6.3
90-day bank bill	7.50%	7.53	7.62	7.62	6.85	6.6
10 year govt. bond	5.64%	5.66	5.67	5.83	5.97	6.5
1 year swap	7.34%	7.36	7.44	7.62	6.92	6.7
5 year swap	6.72%	6.73	6.76	7.09	6.74	7.1
NZD/USD	0.658	0.674	0.684	0.69	0.73	.57
NZD/AUD	0.895	0.913	0.907	0.936	0.92	.86
NZD/JPY	77.9	79.5	78.5	82.0	76.0	66.0
NZD/GBP	0.378	0.388	0.384	0.40	0.38	.35
NZD/EURO	0.553	0.566	0.559	0.585	0.55	.509

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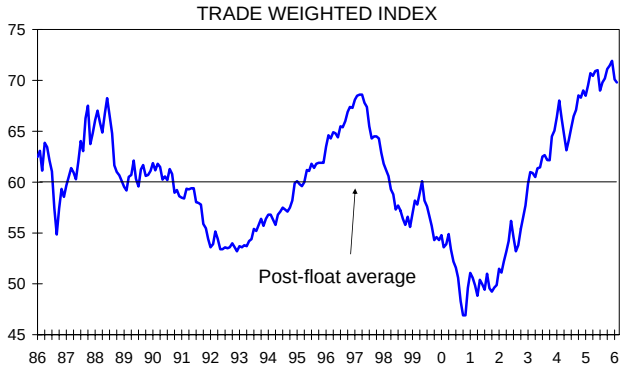
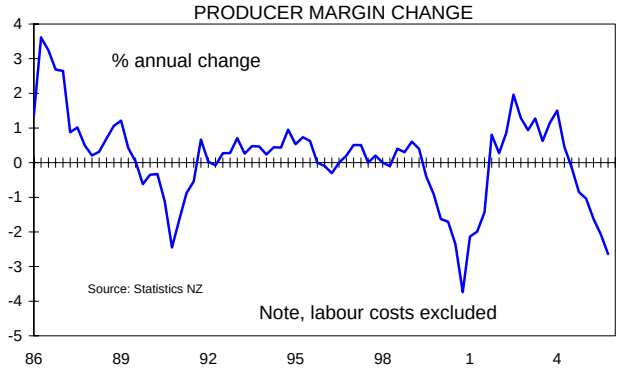
Slowdown Underway

The rate of growth in our economy has fallen from 4.4% in the year to September 2004 to 2.6% in the year to September 2005. We are forecasting that growth will come in near 1.7% this calendar year, fall to 1.5% over calendar 2007, then improve only marginally to just above 2% come 2008. After growth averaging 4% per annum over the past six years this will represent a fairly mediocre performance for our economy. So far the slowdown has occurred in four ways. First, exporters have been badly affected by the currency trading above its long-term average since early 2003. Second, residential construction has been falling for a year and a half following the biggest boom since the 1970s. Third, business margins are under extreme pressure and this is causing cutbacks in capital spending and hiring. Fourth, in some sectors resources are in short supply so companies have had to pare back their rate of expansion.





Looking ahead we expect this slowdown to spread from mainly non-pastoral exporters into dairying, sheep and beef farmers and their spending, and over the second half of the year the mild slowdown in retailing and housing already evident is expected to worsen. This will represent the traditional lagged impact on the domestic economy of weakness in the exporting sector.

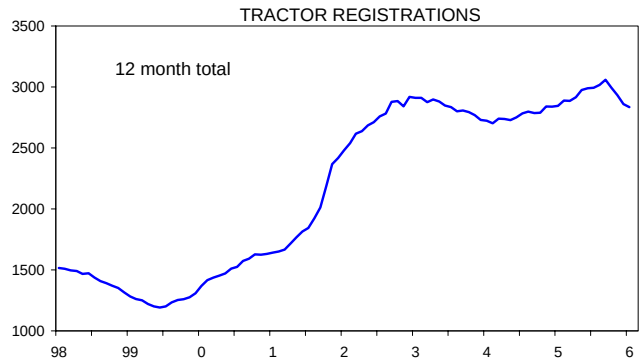
Plus there will be factors like below average population growth, slowly rising average mortgage rates, perhaps some easing of job security, absence of a positive house price wealth effect, general despondency usually seen in the household sector when the currency starts declining, and ending of a period of consumer buying to beat exchange rate induced price rises.

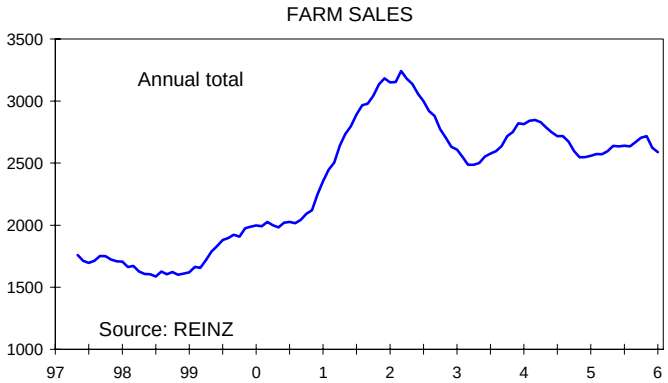
As we have been noting many times over the past two to three years we don't expect to see the economy go into recession this cycle. There is a lot of insulation from reasonable job security, low fixed interest rates, easing fiscal policy, still acceptable commodity prices, infrastructure spending, and reasonable world growth .

The last time our economy had a cyclical downturn in 1998 there was a recession. This led to a lot of questioning about New Zealand's long-term potential and a great out-flow of people from the country. But as we pointed out at the time and for a couple of years afterward there were many special negative factors which came together at once to cause extra weakness while the likes of Australia continued to chug along at about 4%. We were hit by the Asian Crisis, a high exchange rate, a 30% fall in average commodity prices, a sharp turnaround in migration flows, a vicious downward leg to the housing cycle caused partly by the Reserve Bank running an excessively tight monetary policy, and two years of drought slashing farm incomes and spending.

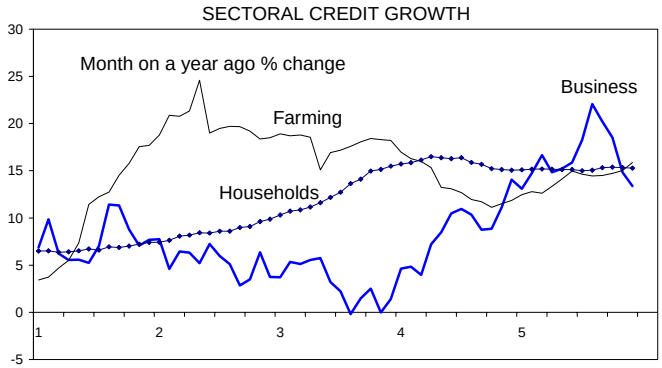
Let's consider the issue of whether this time around the economy is going to be hit by the sort of farm downturn we saw back then. One might have expected that with the New Zealand dollar rising above 65¢ at the start of 2004 that farmers would have pulled back strongly in their spending. But instead we have seen up until recently continued growth in construction of farm buildings, near steady tractor registrations, and continued strong rises in land prices with shortages of farms for sale.

However we can now see evidence that farmers are pulling back their spending. The number of tractors registered in the three months to January was down by 20% from a year earlier. Farm sales in the three months to January where down by 16% from a year earlier. There is some anecdotal evidence that fertilizer application is easing off.

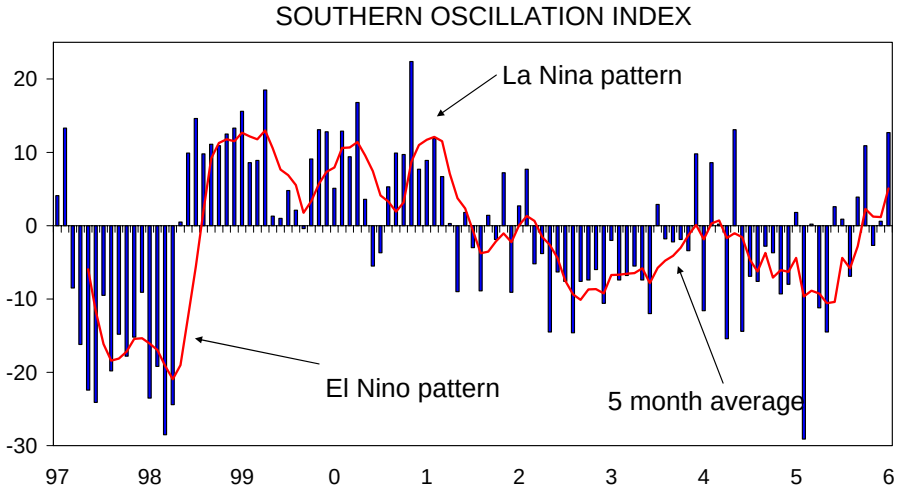




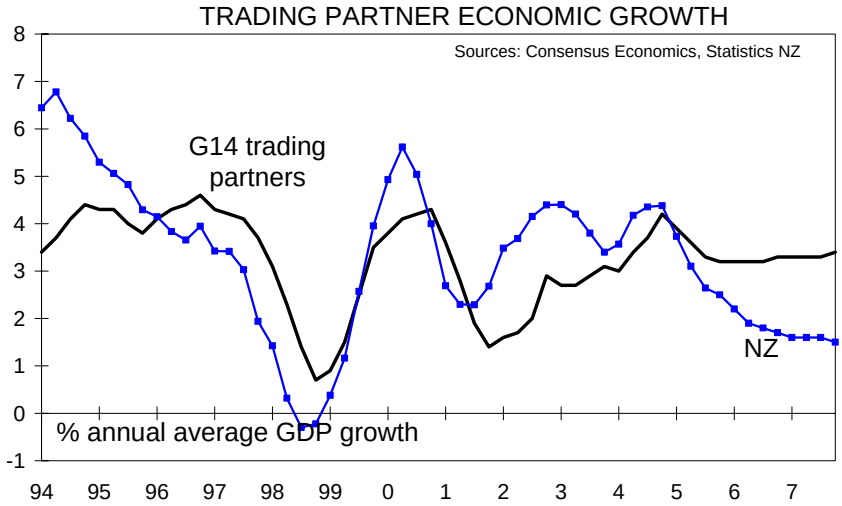
Farmers are undoubtedly reacting to factors such as commodity prices now on average sitting over 5% below the record levels of early last year with some recent extra easing in sheepmeat prices. Confidence about the exchange rate falling sharply has probably taken a dent after two years of inappropriately expecting a large fall, and perhaps there is a general view that some consolidation is advisable after many years of expansion and debt growth.



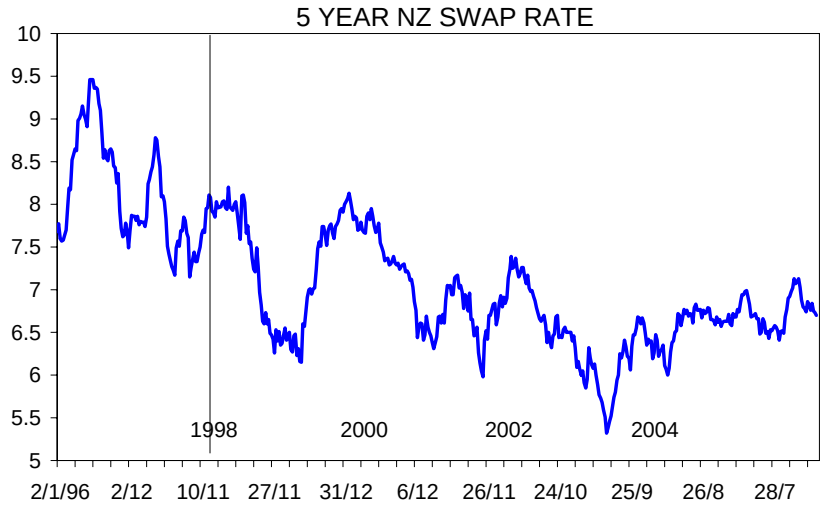
But this is not 1998 and the situation for farming this time around is very different from back then. Of great significance is the fact there is no drought in place. Over 1997 and into 1998 there was a significant El Nino weather pattern. That is absent this time.



Although commodity prices are easing off we do not expect a repeat of the 1996 to 1998 experience. Back then growth in our top fourteen trading partners on average fell below 1% causing commodity prices to fall away sharply. The consensus view at the moment is that foreign growth this year and next year will be close to 3.5%. And importantly, there is confidence from experts in commodity markets that growth in the likes of the Chinese and Indian economies means a firmer long-term underpinning for commodity prices on average than was felt back in 1998. Confidence about long-term commodity prices is likely to cause farmers to limit the extent to which they cut back on long-term capital expenditure.



Farmers [and other borrowers] are not having their cash flows pressured by interest rates at the same level as back then. It is difficult to know which interest rate to use for this comparison but if we focus just on the five year swap rate to which a margin is added for lending to business borrowers fixed for five years we see that the rate currently is around 6.7% compared with 8% back then. In addition we believe more farmers have got low long-term fixed rates locked in this cycle than was the case back then. Floating rates used for financing cash flow deficiencies are also substantially lower with the 90 day bank bill currently near 7.5% versus over 9% back then.



Like all other sectors in the economy during an economic slowdown farmers are going to experience constrained incomes and will cut back on their capital spending, hiring, and purchases of consumer goods and services like televisions and overseas travel. But when farmers see their incomes tightening up they often adjust their spending more quickly than other sectors. This can lead to excessive pessimism from farm service providers about the severity of the farming downturn. But our message to service providers is not to expect this cycle will remotely resemble that of 1998. Interestingly, in line with our view of a mild downward leg to the housing cycle this time around, this means investors looking for juicy bargains in rural real estate may be disappointed.

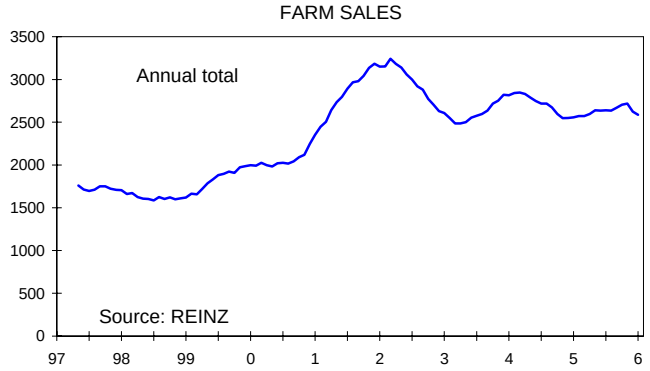
Please note. Next week's overview will be sent out on Wednesday because on Thursday I'll be having the cartilage repaired in my left knee - hence the lack of any tramping references over the past four months. The monthly Confidence Survey will be run on Thursday 9th March all going well. Voice recognition continues to be a struggle with odd words creeping in, but publication production time is improving and will hopefully get better with some new software in a few weeks. Speaking as one should write is proving a challenge.

THE WEEK'S ECONOMIC DEVELOPMENTS

Friday 17

Farm sales falling

In December there were 145 farms sold around New Zealand. This was a 20% fall from a year earlier and followed a 29% decline in December from December 2004. The number of sales in January was the lowest for any January since 2000, while the December result was the lowest since December 1999. In seasonally adjusted terms of sales have fallen by about 20% over the past three months so there is evidence that a wave of caution is sweeping through the farming sector. This seems understandable considering the high level of the New Zealand dollar along with some evidence of falling commodity prices. For the year to January there were 2588 farms sold. This was a 1.1% gain from a year earlier.

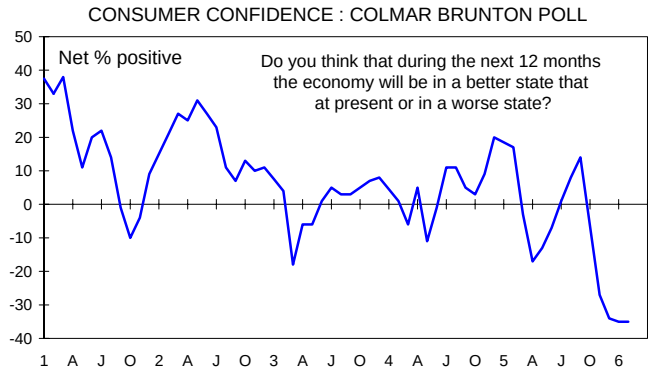


The median farm sale price for the three months to January was $1.2 million. T his was a 7% gain from a year ago and well up from $835,000 three months ago. But we warn that these price data are highly volatile and massively distorted by not just the changes in the mix of farms sold but in their size as well. So we don't use these numbers to give us any particularly good insight into where land prices are going. For that we end up having to rely on anecdotal feedback which at the moment suggests some flattening out in prices.

Monday 20

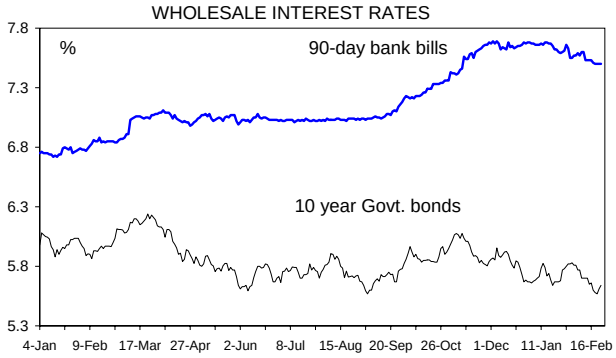
Consumers remain pessimistic

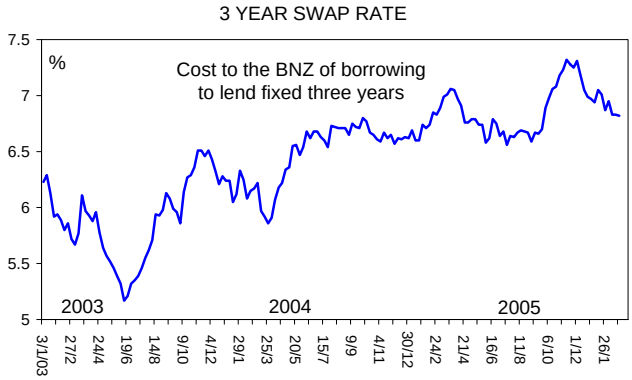
The One News Colmar Brunton poll has revealed no change in consumer confidence since the last survey was conducted in early December. A net 35% of consumers expect that the economy will deteriorate over the coming year from a net 34% back then. The result Is not all that important because there is little correlation in the short term between changes in consumer confidence and changes in consumer spending. But the fact that confidence remains so poor backs up our view that retail spending and the housing market will be easing off as 2006 progresses.



INTEREST RATES

Wholesale interest rates have hardly moved over the past week with a small increase in swap rates and a small decrease in bank bill yields. If anything the decrease in bill yields was a small surprise. This is because the trade weighted index now sits below the level assumed by the Reserve Bank in their latest set of economic forecasts released in December. This means inflation is likely to prove slightly higher than they have predicted and reduces the scope for them to ease monetary policy in the near future. The markets have actually picked up on this fact with expectations of an easing starting to be pushed out from the over-optimistic July timeframe towards September and beyond. But in the physicals market good liquidity is being supplied by the Reserve Bank to ensure the recent maturity of the February 2006 government bonds does not cramp things up.

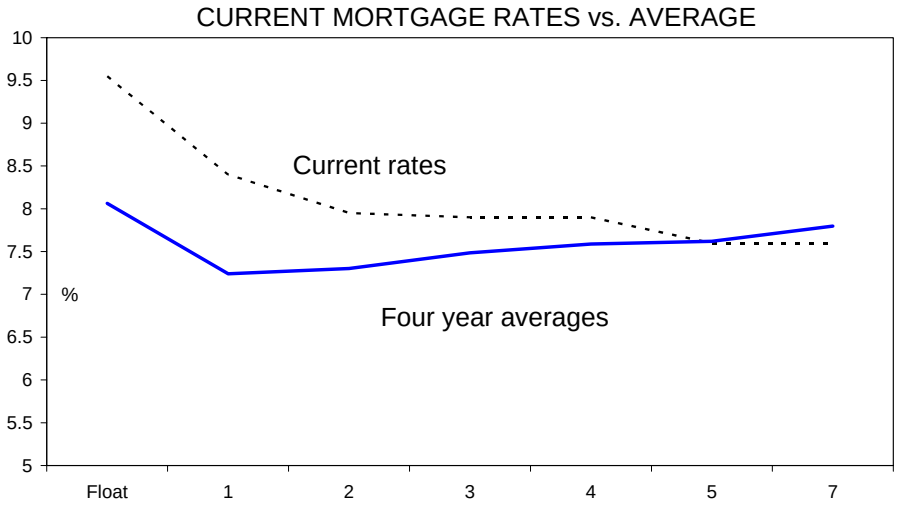




The yield on 90 day bank bills has finished the week at 7.5% from 7.53% last week. The three year swap rate has ended near 6.82% from 6.83% in spite of a decent rally in the U.S. bond market with their ten year bond finishing at 4.53% from 4.61% a year ago. NZ yields have been prevented from falling appreciably by concerns Uradashi bond issuance in coming months will not match maturities.

If I were a borrower what would I do?

The graph just below compares current floating and fixed mortgage rates with where these rates have averaged over the past four years. Unsurprisingly, with monetary policy tight current rates are above average for most terms. But the first interesting thing to note is that the five and seven year terms are almost exactly at their averages. This means that if you are a cautious type of borrower and simply want to get a reasonable interest rate locked in so you can get on with the rest of your life, fixing for five or seven years is quite attractive at the moment.

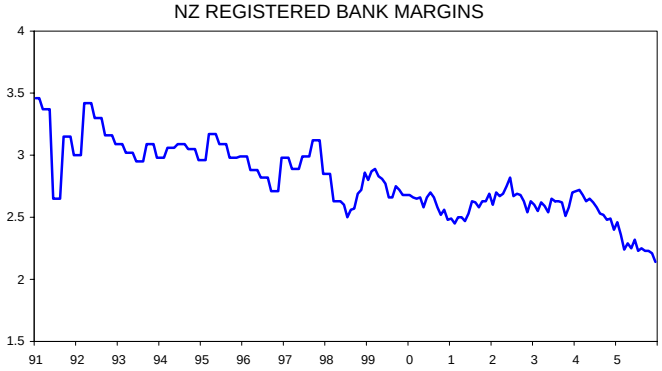


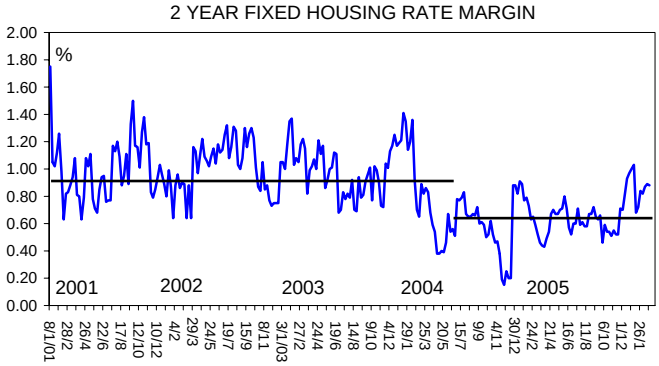
But we Kiwis have a natural preference for the shorter terms and the issue really is one of whether current rates in the two and three year area are so high that you don't want to touch them at all or low enough to choose them as one normally would. We find it easy to decide not to take the one year rate because it is sitting over 1% above its four year average, costs a lot more than any other fixed term, and we don't believe that fixed rates are going to have a major decline in twelve months time which would justify taking the short term pain for major long-term gain. More specifically, we don't think that the likes of the five year fixed rate in a year's time will be back anywhere near the 6.4% or 6.7% seen in 2003 when there were major concerns about deflation in the United States.

If one fixes in the two or three year area you'll be paying close to half a percent above the average for the past four years and about 0.3% more than if you fix for one of the longer terms. However history shows that nice low fixed rates tend to come around every two to three years and it is good to have the opportunity to take advantage of these low rates when they appear.

So my personal preference is for the two year rate. Note that in the graph above we've included the current floating rate of 9.55% which is well above the four year average of about 8%. If you are choosing to float at the moment then one would suggest you must be expecting something nasty to come along like bird flu which would cause major economic weakness and a collapse of interest rates. We don't have this expectation and therefore floating interest rates will probably only best suit those who have always paid them, are comfortable with them, have done their short term budgeting upon them and probably only have a small amount left on the mortgage.

Alternatively, if you are rolling off an existing fixed rate you might be thinking about going floating to see what the existing fixed rates are going to do in the next few weeks. With regards to the swap rates at which we banks borrow to lend fixed we don't have a strong view one way or the other on what with these rates are going to do. But that doesn't mean the housing fixed rates will remain unchanged. It is a very competitive marketplace out there, as shown in the following graph. This shows the spread between the cost of money to all of us registered banks in New Zealand for all borrowing and the rate which we lend out at. Fifteen years ago the margin was around 3%. Seven years ago it was around 2.7%. Now the margin is close to 2.1%. The second graph shows the margin on the two year fixed home lending rate.





Poor us. Note that a key cause of the margin decline over the past couple of years has been the increase in the proportion of housing loans at fixed as opposed to floating interest rates.

The strength of competition means that one can never rule out margins for a while being held at unusually low levels.

BNZ Fixed Lending Interest Rates

	Housing	Business Advantage*	Farm First*
Float	9.55%	9.85%	9.80%
1 yr	8.40	9.20	9.05
2	7.95	9.10	8.85
3	7.90	8.95	8.80
4	7.90	8.85	8.70
5	7.60	8.80	8.65
7	7.60	-	8.55
10	-	-	8.55

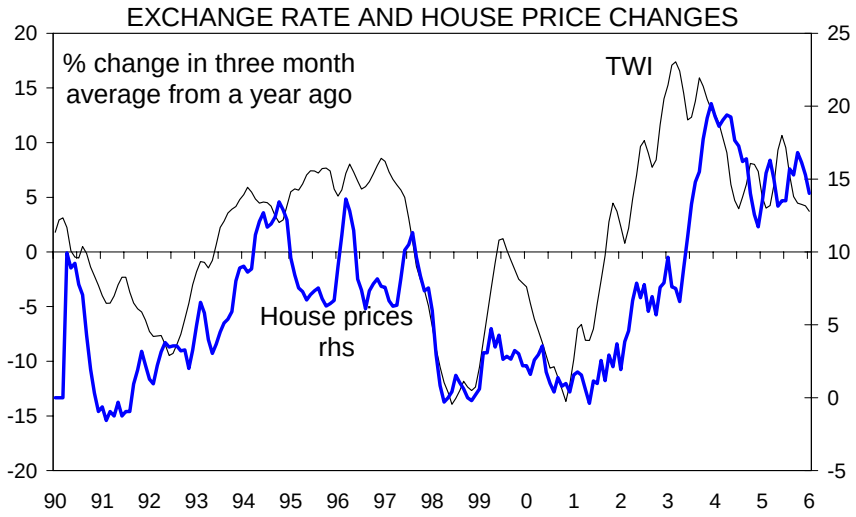
* Rates shown do not include normal margins.

BNZ Term Deposit Rates

Days	$10-50K	$50-100K	$100-250k
30	3.00	3.00	5.25
90	5.90	5.95	6.00
180	6.80	6.85	6.90
1 yr	7.00	7.05	7.10
5 yr	6.40	6.45	6.50

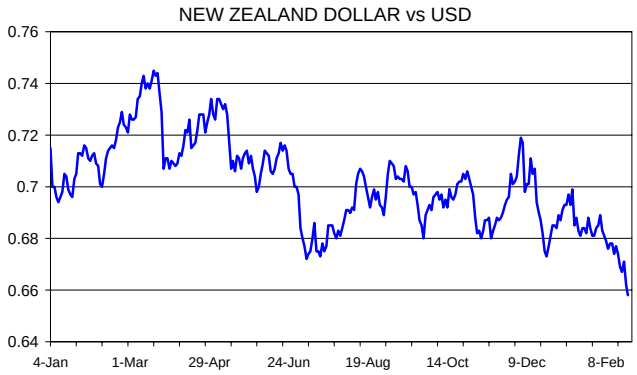
HOUSING MARKET UPDATE

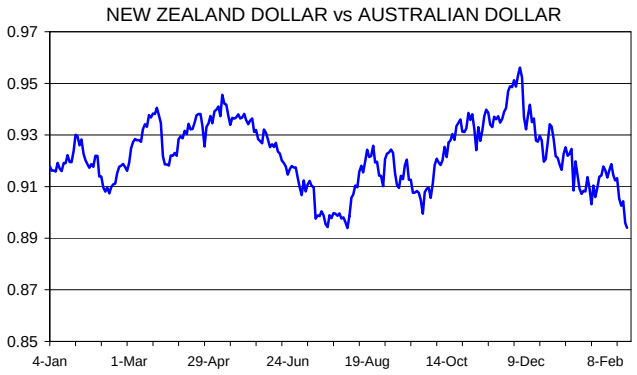
We have received no new information on the housing market over the past week and wrote enough last week surely to satisfy the most voracious commentary appetite. Having said that one is never short of something to add and during the week we had an emailer asking us to repeat the graph showing the correlation between movements in the exchange rate and movements in house prices. So here it is. Note that the correlation is far from perfect and applies more for trends lasting a few years than monthly, quarterly or even annual changes



EXCHANGE RATES

The Kiwi dollar has fallen one and a half cents against the U.S. dollar over the past week and about 1¢ against the Australian dollar. We are currently trading near US 65.8¢ and 89.4¢ against the Australian dollar. We have also weakened against the British pound to 37.8 pence from 38.8 a week ago, and against the Euro to 55.3¢ from 56.7. Against the Japanese yen we are down near 77.9 from 79.5 last week.

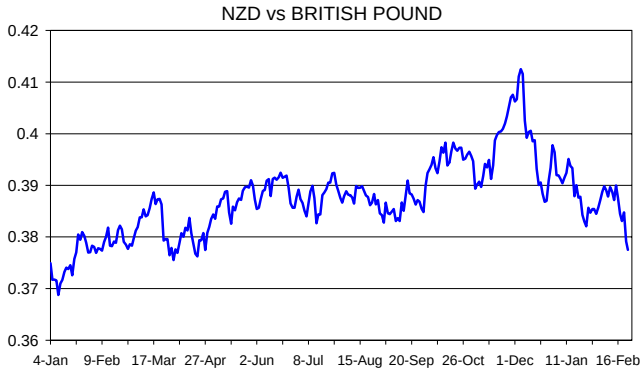


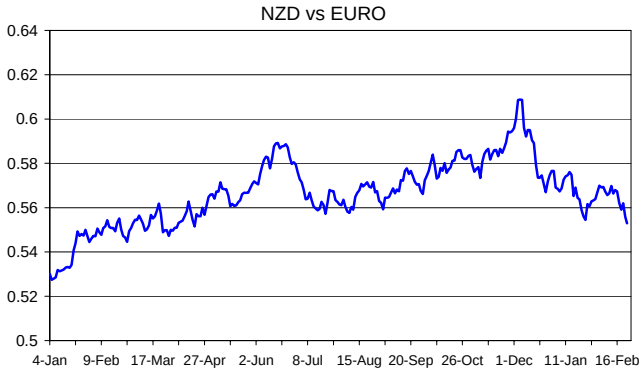


We are now at almost an eighteen month low against the U.S. dollar and 21 month low against the Australian dollar.

Our currency has been pushed lower by a combination of factors. One is the widespread knowledge that the Kiwi dollar is overvalued having reached a post float high against the greenback almost a year ago and is on a slow downward drift. Second, there was a rumor that a Japanese investment house had told its

salespeople to stop promoting New Zealand dollar debt. Third, there was another rumor that a U.S. investment bank was advising investors to buy Australian dollars and sell New Zealand dollars.

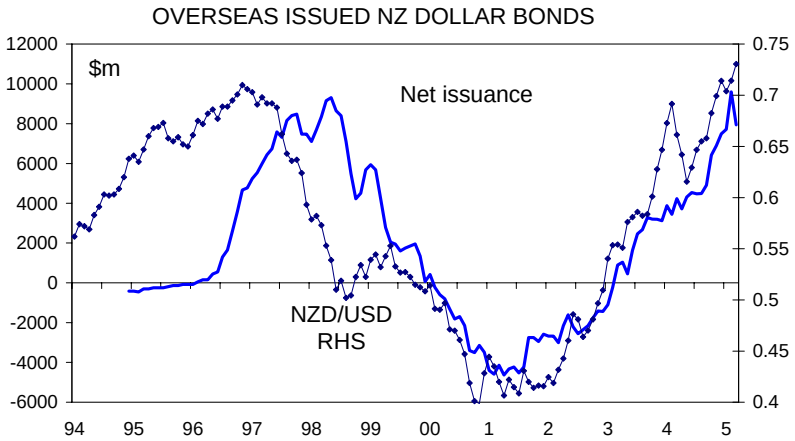




Along with awareness of the Kiwi dollar being well overvalued there is a growing view in the marketplace that risk aversion will rise as the year proceeds. This means investors will tend toward safer, larger markets such as for the yen the Euro and the U.S. dollar and edge away from more peripheral currencies like the New Zealand dollar and Australian dollar. This risk aversion is expected to arise on the back of eventually tightening monetary policy in Japan slowing down the rate of growth in their liquidity and therefore global liquidity, along with further rate rises in the United States and probably Europe going by the comments from the European central bank governor in recent weeks.

The Uradashi selling rumour may be unfounded but it relates to a very important issue. There is about $45 billion worth of Kiwi dollar denominated debt issued overseas which is a outstanding. A year ago the amount outstanding was just over $20 billion. As the Reserve Bank noted in it's memorandum on Uradashi issuance compiled in early December last year, during the months of August, October, and November the most common currency for foreign bond issuance in Japan was New Zealand dollars. The way in which the Uradashi bonds impact on the Kiwi dollar is twofold. First there are fresh issues which create demand for New Zealand dollars. So far almost $2 billion worth of such bonds have been issued this year. There is essentially no information ahead of time on the volume of issuance so the market simply digests information about issues as they occur.

But we know in full detail the volume of maturing Uridashi issues. These maturities start getting large from the middle of this year. The big question is whether there will be new issues to offset these maturities. The rumor regarding Japanese investment banks ending their promotion of Kiwi dollar denominated securities increases the chances that these maturities will not be matched by fresh issuance hence the weakness in the Kiwi dollar now. We haven't had time to get full up to date data but older information allowed us last year to run a graph looking at the correlation between net insurance of overseas issued New Zealand dollar bond and the NZD/USD exchange rate. The relationship is fairly clear and this is why we are seeing some Kiwi dollar weakness at the moment.



Going back to the first factor mentioned above as causing the Kiwi dollar to go down, namely an awareness that it is overvalued and will eventually fall strongly, the expectation is that much of this fall will be driven by a weak economy. Recently the markets have focused on weak economic data. These include recent releases showing weak manufacturing, depressed consumer sentiment, falling dwelling sales with flat prices, weak headline retail sales, high business pessimism, and poor reports from export sectors such as tourism, pipfruit, forestry, fishing, and more recently farming.

But not all the data have been bad. Dwelling consent numbers in seasonally adjusted terms jumped by 21% in December. Core retail spending rose by a still acceptable 1.1% during the December quarter. Car registrations in January were up 7% from a year earlier. Household debt growth remains strong at a seasonally adjusted 1.1% in recent months with annual growth still over 15%. The reporting season also appears to have been a good one for listed companies.

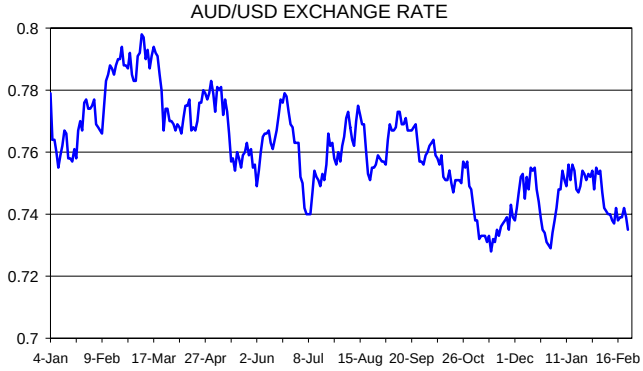
But the real issue is whether the weakening in growth which is under way will be enough to alleviate capacity constraints by enough in the short term to stop the Reserve Bank being scared of inflation consolidating at a high level. We think they are a long, long way off feeling happy. That means to the extent the Kiwi dollar fall is based on market expectations of the Reserve Bank slashing interest rates soon this period of currency weakness may not amount to all that much in the short term.

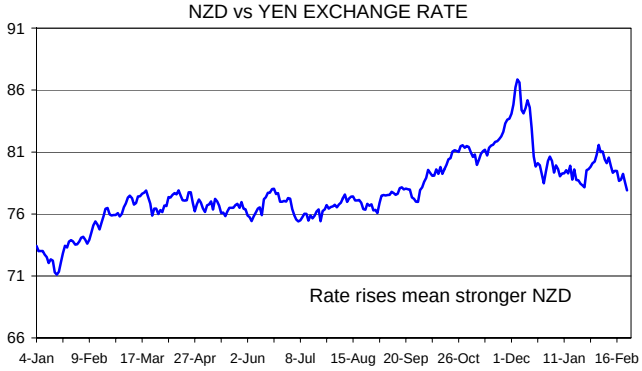
Although employment growth was 0% during the December quarter the unemployment rate fell to a record low of 3.6% from 3.7% in the September quarter. The capacity utilization measure produced by the NZIER Quarterly Survey of Business Opinion remained well above average at 91.5% in the December quarter. We think it will take a long time before capacity pressures are substantially reduced in our economy -- and by a long time we mean an extended period of slow growth around 1.5% per annum. It is worth remembering that the Reserve Bank forecast no easing in monetary policy before 2008 even though they have a similarly downbeat view on growth over the next two to three years as ourselves.

With the annual rate of inflation expected to rise to 3.5% when the March quarter numbers are released in mid-April we think the Reserve Bank will remain very scared about inflation. In particular they will become concerned that in a still capacity constrained economy a falling currency will rapidly feed-through into wage and price setting behavior.

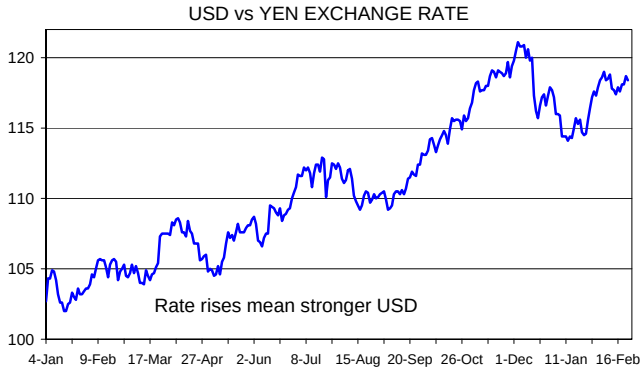
Already in the financial markets pricing for the timing of the first easing has moved out from July toward September. The risk is that if the Kiwi dollar does happen to fall further in the short term (and it is near impossible to predict such things) the Reserve Bank may have to respond by warning that if inflationary pressures surprise on the top side they will need to raise interest rates again. In particular, it is worth noting that with the trade weighted index (TWI) now sitting near 68, this is about 3% less than the Reserve Bank have assumed for the March quarter.

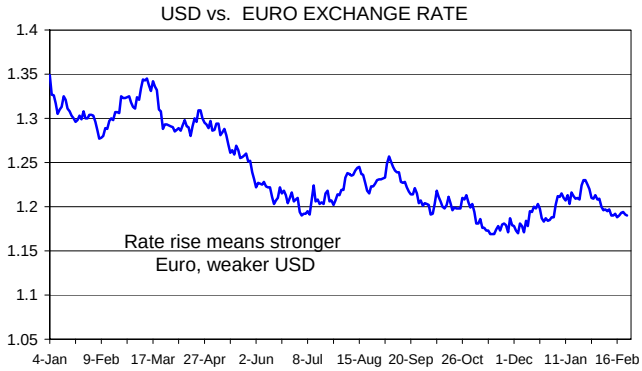
The Australian dollar has also fallen against the greenback over the week but not by as much as the Kiwi. It has ended near 73.5¢ from 73.8 last Thursday. The AUD has received some support from comments by the RBA Governor last Friday where he indicated that upside risk for interest rates still exists. In addition there has been some selling of the Kiwi dollar to buy Australian dollars.





The U.S. dollar itself has moved little over the past week ending practically unchanged against the pound and Euro but up slightly against the yen near 118.4 from 117.6 yen last week.





The greenback weakened slightly after the mid-February University of Michigan consumer confidence number came in a weaker than expected at a reading of 87.4 from 91.2 in January. A reading of 91 had been expected. But it has strengthened overnight on the back of oil prices falling $2.00 in response to higher than expected inventories, plus the Dow Jones index hitting its highest level in four and a half years.

The Federal Reserve released the minutes of their last Open Market Committee meeting and they were fairly much as expected. The Fed. noted that underlying inflationary pressures could still lead to further rate hikes and whether this happens or not will depend upon how the economic data plays out. The comments were consistent with those that came when the funds rate was recently raised to 4.25% and in testimony before Congress of the new Federal Reserve Chairman Mr. Bernanke. They mean that a lot of attention is now being paid to data releases. If two or three pieces of data come together showing the economy weaker than expected expectations of further rate rises will tend to fall and this will generate some weakness in the U.S. dollar. Conversely a string of strong data will lead to heighten expectations of rate rises and the U.S. dollar will strengthen which has been the general theme over the past two to three weeks.

BNZ WEEKLY OVERVIEW

ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	0.7%	1.1	3.2	2.7	1.6
GDP growth	Average past 10 years = 3.3%	0.2	1.2	2.6	4.4	3.9
Unemployment rate	Average past 10 years = 5.7%	3.6	3.7	.....	3.6	4.6
Jobs growth	Average past 10 years = 2.1%	0.0	1.5	1.6	4.4	2.6
Current a/c deficit	Average past 10 years = 4.9% of GDP	8.5	8.0	.....	6.0	4.3
Terms of Trade		-0.5	-1.3	0.7	7.3	2.2
Wages Growth	Stats NZ experimental series	1.3	1.7	5.3	5.1	4.9
Retail Sales ex-auto	Average past 9 years = 4.2%.	0.9	1.8	5.1	7.8	5.9
House Prices	Long term average rise 4.2% p.a.	2.6	2.7	14.0	16.4	21.2
Net migration gain	Av. gain past 10 years = 13,000	+6,960	6,145yr	.....	12,808	34,906
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 8%. Colmar survey	-35	-34	8	17	1
Business activity exps	10 year average = 27%. NBNZ	-2	0	7	27	30
Household debt	10 year average growth = 11.4%. RBNZ	15.3	15.3	15.1	15.1	15.5
Dwelling sales	10 year average growth = 4.6%. REINZ	-10	-18	5	-16	3
Tourist numbers	10 year average growth = 6.1%. Stats NZ	-1.9	-2.7	16.9	5.3	11.9
Floating Mort. Rate	10 year average = 8.5%	9.55	9.50	9.00	8.75	7.25
3 yr fixed hsg rate	10 year average = 8.2%	7.85	8.15	7.45	7.60	7.60

ECONOMIC FORECASTS

Forecasts at Jan 26 2006	**March Years**					**December Years**				
	2005	2006	2007	2008	2009	2004	2005	2006	2007	2008
GDP - annual average % change										
Private Consumption	5.8	4.5	1.6	0.5	1.1	6.5	5.1	2	0.7	0.8
Government Consumption	5.2	2.4	5.9	3.5	3.6	5.7	3.1	5.1	4.2	3.1
Investment	7.8	6.2	0.3	1.8	3.6	13.2	4.8	1.3	1.4	3.1
GNE	6.5	4.6	1.6	1.4	2.3	8.2	5	1.9	1.5	1.9
Exports	3.9	1.2	3.2	3.2	4.6	5.6	-0.1	3.3	3.1	4.1
Imports	13.7	7.7	3.4	2.5	3.2	16.6	8	4.2	2.7	2.9
GDP	3.7	2.5	1.5	1.6	2.7	4.4	2.5	1.7	1.5	2.2
Inflation – Consumers Price Index	2.8	3.4	2.9	3.2	2.1	2.7	3.2	3	3.3	2.2
Employment	3.4	2	0.5	0.5	1.1	4.4	1.8	0.6	0.4	0.9
Unemployment Rate %	3.9	3.6	3.8	3.9	3.7	3.6	3.4	3.8	4	3.9
Wages	2.9	4.6	4.2	3.4	2.6	1.9	4.8	4.5	3.5	2.8
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.73	0.67	0.57	0.59	0.6	0.71	0.7	0.58	0.58	0.6
USD/JPY	105	115	102	110	111	104	119	105	108	111
EUR/USD	1.32	1.2	1.15	1.19	1.16	1.34	1.19	1.16	1.18	1.17
NZD/AUD	0.93	0.91	0.85	0.83	0.85	0.93	0.94	0.85	0.83	0.85
NZD/GBP	0.38	0.39	0.34	0.35	0.36	0.37	0.4	0.35	0.34	0.35
NZD/EUR	0.55	0.56	0.5	0.5	0.52	0.53	0.59	0.5	0.49	0.51
NZD/YEN	76.8	77.1	58.1	64.9	66.7	74.2	82.7	60.9	62.6	66.5
TWI	70.7	68.7	59.3	60.7	62.5	69	71.9	60.2	59.8	62
Official Cash Rate	6.56	7.25	7	6	5.75	6.43	6.99	7.25	6.25	5.75
90 Day Bank Bill Rate	6.86	7.55	7.2	6.2	5.95	6.73	7.49	7.45	6.45	5.95
10 Year Govt Bond	6.04	5.85	5.9	5.7	5.7	6.03	5.89	5.95	5.75	5.7

All actual data excluding interest & exchange rates sourced from Statistics NZ.

The BNZ Weekly Overview is prepared by Tony Alexander, Chief Economist at the Bank of New Zealand. Ph 04 474-6744.